IT 96-56
Tax Type: INCOME TAX
Issue: 1005 Penalty (Reasonable Cause Issue)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	)	
	)	**No.**
	)	**FEIN**
v.	)	**TAX YRS. 12/31/91 & 92**
	)	
TAXPAYER	)	**Administrative Law Judge**
	)	**Charles E. McClellan**
Taxpayer	)	
	)	

RECOMMENDATION FOR DISPOSITION

APPEARANCES: Mr. Shepard Smith, Special Assistant Attorney General, for the Department of Revenue; Mr. Richard M. Lipton and Ms. Jane Wells May, of Sonnenschein, Nath & Rosenthal, for TAXPAYER.

Synopsis:

This matter came on for hearing pursuant to the taxpayer's timely protest of a Notice of Deficiency ("NOD") issued to TAXPAYER by the Department of Revenue dated December 9, 1994, for Illinois Income Tax ("IITA") for the years ended December 31, 1991 and December 31, 1992. A hearing was held on February 6, 1996, following which, both parties filed briefs. The issue is whether the taxpayer acted reasonably and in good faith in the way it calculated the addition modification set forth in § 203(b) of the IITA (35 ILCS 5/203(b)) for tax exempt interest so that the penalty assessed against the taxpayer under § 1005 of the IITA (35 ILCS §5/1005) should be abated. Following the submission of all evidence and a review of the record, it is recommended that the penalty be abated and this matter be resolved in favor of the taxpayer.

Findings of Fact:

1. The parties entered a stipulation of fact with eleven exhibits attached. (Tr. p. 7).

2. The Department's *prima facie* case against TAXPAYER, including all jurisdictional elements, was established by the admission into evidence of the Notice of Deficiency (Stip. Ex. 6).

3. Taxpayer is an Illinois corporation with its principal place of business in Bloomington, Illinois. (Stip. ¶ 1).

4. Taxpayer is principally engaged in business as a property and casualty insurance company. (Stip. ¶ 2).

5. The tax years in issue are calendar years 1991 and 1992. (Stip. ¶ 3).

6. The federal tax treatment of property and casualty insurance companies was amended in 1986 for 1987 and subsequent years by the Tax Reform Act of 1986 ("TRA"). (Tr. p. 17).

7. The 1986 Act amended Internal Revenue Code ("IRC") § 832(b) to require that insurance companies reduce their deduction for losses incurred by 15% of the tax exempt interest received or accrued during the taxable year. (Tr. p. 31).

8. Taxpayer filed its consolidated federal income tax return (Form 1120-PC) for 1991 on or about August 24, 1992. (Stip. ¶ 4).

9. Taxpayer filed its IL-1120 Illinois income tax return (combined) for 1991 on or about August 24, 1992. (Stip. ¶ 5).

10. Taxpayer filed its consolidated federal income tax return (Form 1120-PC) for 1992 on or about September 14, 1993. (Stip. ¶ 6).

11. Taxpayer filed its IL-1120 Illinois income tax return (combined) for 1992 on or about September 14, 1993. (Stip. ¶ 7).

12. In computing its federal taxable income for 1991 and 1992, taxpayer was required to reduce losses incurred by 15% of the net amount of its tax exempt interest. (Stip. ¶ 8; Tr. p. 31).

13. Prior to preparing and filing its Illinois Income Tax returns for 1991 and 1992, taxpayer consulted with its outside tax advisors regarding the proper reporting of the exempt interest addition modification. (Tr. pp. 39, 40).

14. On its Illinois income tax returns for 1991 and 1992, after consulting with outside advisors, taxpayer reported as an addition modification the net amount of its tax exempt interest (i.e., the total amount of tax exempt interest excluded from federal gross income less 15% of the amount of tax exempt interest taxpayer was required to subtract from its losses incurred deduction for federal income tax purposes.) (Stip. ¶ 9; Tr. p. 39, 40).

15. On audit, the Department increased the tax exempt interest addition modification by 15% of the amount of tax exempt interest taxpayer subtracted from its losses incurred deduction for federal income tax purposes. (Stip. ¶ 10).

16. The Department issued a NOD dated December 9, 1994, assessing a statutory deficiency in the amount of $336,882, which included a penalty assessed under § 1005 of the Act. (35 ILCS 5/1005) (Stip. ¶ 13).

17. Taxpayer paid the tax deficiency and interest but not the § 1005 penalties which it protested and are at issue in this proceeding. (Stip. ¶¶ 13, 14).

18. The Department also issued a NOD for the calendar years 1988 and 1989 dated August 11, 1992. (Stip. ¶ 13).

19. The deficiency for 1988 and 1989 was also based on the addition modification adjustment for 15% of tax exempt interest which taxpayer had subtracted from its losses incurred for federal income tax purposes for each year. (Stip. ¶ 15).

20. Taxpayer paid the asserted deficiency for 1989 and 1990 and filed a suit in Sangamon County under the Protest Money Act. (Stip. ¶ 16).

21. In the Sangamon case the issues were whether § 203(b)(2)(A) of the IITA required taxpayer to increase its addition modification for 1988 and 1989 by an amount equal to 15% of its tax exempt interest income earned each year and whether Section 1005 penalties should be assessed. (Stip. ¶ 17).

22. In the Sangamon case and in its Illinois tax returns for 1990 and 1991, taxpayer took the position that it was entitled to reduce its addition

modification by the 15% of tax free interest because, in substance, the 15% tax exempt interest amount was included in federal taxable income through the offset against incurred losses on its federal income tax return. (Stip ¶ 18; Tr. p. 40).

23. The Department took the position that the addition modification for exempt interest should be the gross amount of tax exempt interest income excluded from gross income on taxpayer's federal income tax return, *i.e.*, including the 15% portion that reduced the taxpayer's incurred losses deduction for federal income tax purposes. (Stip. ¶ 19).

24. The Sangamon case was settled in April 1994 (after the dates the taxpayer's Illinois income tax returns for 1991 and 1992 were filed) as the result of an agreement in which the taxpayer agreed to the addition modification adjustment and the Department conceded the Section 1005 penalty issue. (Stip. ¶ 20, 21; Stip. Ex. 11).

25. At the time the 1991 and 1992 returns were filed, the question was unresolved between the taxpayer and the Department as to whether the federally tax exempt interest should be an addition modification in total or net of the 15% incurred loss offset. (Tr. p. 21).

26. As part of the settlement agreement for the years 1987 through 1990, the Section 1005 penalty assessments were abated. (Tr. p. 22).

27. Since the Sangamon case was settled, taxpayer has filed its Illinois income tax returns reporting its tax exempt interest addition modification in a manner that is consistent with the resolution of the issue for the 1989 and 1990 years and has consented to the addition modification adjustment regarding the years at issue in this matter. (Stip. ¶ 23).

Conclusions of Law:

The record in this case shows that this taxpayer has demonstrated by the presentation of the stipulation, testimony, exhibits and argument, evidence sufficient to overcome the Department's *prima facie* case of penalty liability under the assessment in question. Accordingly, under the reasoning given below,

the assessment of penalties under IITA § 1005 should be abated: This conclusion is based on the following analysis:

Analysis:

IITA § 1005 imposes a penalty for underpayment of tax required to be shown on a taxpayer's Illinois Income Tax return. The penalty is assessed as provided by the Uniform Penalty and Interest Act ("UPIA"). (35 ILCS 5/1005). UPIA § 3-8 provides that no penalty is to be assessed if the underpayment is due to reasonable cause. (35 ILCS 735/3-8). The statute does not define "reasonable cause" and there are no reported cases dealing with the issue.

The taxpayer cites DuMont Ventilation Company v. Department of Revenue, 99 Ill.App.3d 263 (3rd Dist. 1981) in which the Court addressed the application of § 10-1002(c)(2) of the IITA, since repealed, in a case where the statutory withholding tax filing requirements had been changed as they applied to the taxpayer from monthly filing to quarter-monthly filing. Section 10-1002(c)(2) imposed a late payment penalty unless the failure to timely pay was due to reasonable cause and not due to willful neglect. The taxpayer in DuMont was unaware of the change, its outside accountants were unaware of the change, the Department had not notified the taxpayer of the change, and the taxpayer had a history of timely compliance with the law up to the time the law changed. The Court examined all of the facts and circumstances in that case, concluded there was reasonable cause for taxpayer's failure to pay timely and ordered the penalty assessment to be vacated. The Department objects to reliance on the decision in Dumont Ventilating Company, *supra*, because the case pre-dated the enactment of IITA § 1005 and because it dealt with a section of the statute that has since been repealed. Although, that case did deal with a repealed section, it does provide some guidance as to what constitutes reasonable cause. The factors cited in that case for a finding of reasonable cause are somewhat similar to those in this case. Furthermore, they are consistent with the factors set forth in the Department's regulation.

The Department's regulation interpreting the term "reasonable cause" as used in the statute states that reasonable cause is to be determined on a case by case basis taking into account all of the facts and circumstances. (86 Admin. Code ch. I, § 700.400 (b)). The most important factor is the extent to which the taxpayer made a good faith effort to determine the correct tax liability. *Id*. A taxpayer is considered to have made a good faith effort if he uses ordinary business care and prudence in this regard. (86 Admin. Code ch. I, § 700.400 (c)). Factors which are considered in determining whether the taxpayer exercised ordinary business care and prudence are the clarity of the law and its interpretation, and the taxpayer's experience, knowledge and education. *Id*. The regulation at subparagraph (e) presents a non-exclusive list of examples, none of which are helpful in this case. Thus, a determination of whether the taxpayer acted reasonably and in good faith in calculating the addition modification for its tax exempt interest income for 1991 and 1992 in this case requires an analysis of the clarity of the statute and the statutory interpretation of both parties.

Prior to enactment of the TRA in 1986, the taxpayer and other insurance companies in the same line of business were allowed to deduct, for federal income tax purposes, the full amount of "losses incurred" as that term is defined in the statute. The TRA amendment to the IRC inserted a provision that required, beginning with 1987, that these companies reduce their losses incurred deduction each year by "an amount equal to 15% of . . . tax exempt interest received or accrued during such taxable year." (IRC § 832(b)(5)(B). This change in the IRC caused confusion in the interpretation of the addition modification provision for tax exempt interest under the IITA for 1987 and later years.

The IITA provides that the starting point for a corporation to calculate Illinois income tax is federal taxable income. (35 ILCS 5/203 (b)). This amount is then modified by specified additions and subtractions. The modification that is involved in this case requires the addition of "[a]n amount equal to all

amounts paid or accrued to the taxpayer as interest . . . during the taxable year to the extent excluded from gross income in the computation of taxable income." (35 ILCS 5/203(b)(2)(A)). The IITA contained this language both before and after the TRA.

The 1986 amendment to the IRC had the arithmetical effect of increasing the taxpayer's federal taxable income by 15% of its tax exempt interest. The taxpayer interpreted the statute broadly, taking the position that the 15% amount of tax exempt interest that was subtracted from its loss deduction did not have to be added back since it was already included in federal taxable income as a result of being a reduction of the losses incurred deduction that otherwise would have been allowable. The taxpayer concluded that to include it in the addition modification would have the effect of double taxation of the 15% tax exempt interest amount. Under the taxpayer's interpretation, which it applied to the calculation of its modification for 1991 and 1992, the arithmetic effect of the amendment to IRC § 832(b) was eliminated from the calculation of its Illinois taxable income.

The Department, on the other hand interpreted the modification language narrowly, taking the position that since the 15% amount was not included in the taxpayer's gross income for federal income tax purposes but, rather, found its way into the taxpayer's taxable income by being subtracted from the loss deduction, it was required to be added back. Both interpretations are rational. However, the Department's approach results in a higher tax calculation than does that of the taxpayer.

The Department argues in its brief that taxpayer's position regarding the modification was unreasonable. The Department first argues that the settlement and the concession to the Department's adjustment was based on the merits of the Department's position. (Dept. Br. p. 2). There is nothing in the record to indicate that the taxpayer conceded the modification adjustment based on the merits. The testimony of the taxpayer's controller, XXXXX, (Tr. pp. 41, 42) and

the context of the settlement letter addressing the issue for the prior years (Stip. Ex. 11) suggest that the settlement was reached for other reasons.

Next, the Department argues that the law was clear because the "87 Notice of Deficiency setting forth the Department's correct position had been issued for a year." (Dept. Br. p. 10). The Department cites no authority to support its argument that a position taken on a prior audit, whether agreed to by the taxpayer or not, serves to clarify the law or to serve as legal precedent. Even the settlement agreement entered into by the Department and the taxpayer for the 1989 and 1990 years did not clarify the law or serve as legal precedent. § 203(b) of the Illinois Income Tax was not changed after the IRC was amended in 1986 to address the issue presented in this case. The fact that the taxpayer filed its tax returns for 1991 and 1992 knowing that the Department's position on the addition modification requirement was contrary to its own, does not prove that it was acting unreasonably or in bad faith. The record indicates that the same issue was raised with numerous other insurance companies (Stip. Ex. 11) which shows that the federal change had made the interpretation of § 203(b) unclear, and the Department did not have a regulation on point.

A taxpayer's position in a case like this is clear. "As one may so arrange his affairs that his taxes shall be as low as possible, he is not bound to choose that pattern which will best pay the treasury; there is not even a patriotic duty to increase one's taxes." Helvering v. Gregory, 69 F.2d 809, (CCA 2, 1934) "Nobody owes any public duty to pay more than the law demands. Taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant." Dissent of J. Learned Hand, Comm. v. Newman, 159 F.2d 848, 851 (CA 2, 1947); Estate of Reiner 12 TC 913 (1949).

In this case, the Tax Reform Act of 1986 changed the arithmetical calculation of taxpayer's federal taxable income with its consequential flow through to the taxpayer's Illinois taxable income. Taxpayer consulted with outside advisors on the issue of the proper way to calculate its addition

modification for tax exempt interest. There was then and still is no published authority in support of the Department's position or that of the taxpayer. The fact that the taxpayer knew that the Department interpreted the statute differently than it or the other insurance companies, did not require the taxpayer to adopt the Department's position, especially since the taxpayer litigated the issue at the first opportunity and that determination was not yet made when the taxpayer filed for the years at issue. Thus, either position can be considered reasonable at the pertinent time. Accordingly, the taxpayer was entitled to prepare its tax returns using the interpretation most favorable to it. Considering all of the facts and circumstances, the taxpayer's interpretation of Section 203(b) of the Act was reasonable and made in good faith and constituted reasonable cause for the underpayment.

WHEREFORE, for the reasons stated above, it is my recommendation that the Department's assessment of Section 1005 penalties should be abated.

Date

Charles E. McClellan
Administrative Law Judge